

Economics

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Commentary 2	Criterion A: Diagrams	Criterion B: Terminology	Criterion C: Application	Criterion D: Analysis	Criterion E: Evaluation	Total marks	Nature of the article
Marks awarded for each criterion available	3 /3	2 /2	2 /2	3 /3	4 /4	14 /14	Good.
Comments	One of the best commentaries that I have ever read. Sophisticated analysis + conclusion.					Overall comments Outstanding commentary.	



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China inflation hits 7-month low, eases tightening fears

BY AILEEN WANG AND KEVIN YAO

BEIJING Thu Jan 9, 2014 12:26am EST

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A customer picks up a shoe at a shop where posters advertising price discounts are hung, outside a department store in Beijing, October 23, 2013.

CREDIT: REUTERS/KIM KYUNG-HOON

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(Reuters) - China's annual consumer inflation slowed more sharply than expected to a seven-month low of 2.5 percent in December, easing market fears of monetary policy tightening although the central bank is tapping the brakes on bank liquidity.

Rising money market rates and bond yields indicate the People's Bank of China (PBOC) is targeting bank liquidity conditions to reduce debt levels and contain credit growth, but there is little sign of a sharp turnaround in its policy stance.

The central bank has pledged to continue to maintain prudent monetary policy in 2014 and keep reasonable money and credit growth to support the real economy.

"Inflation pressures remain modest, which will allow policymakers to continue focusing on policies to support growth while implementing structural reform measures in 2014," said Xiaoping Ma, an economist at HSBC in Beijing.

The drop in inflation last month, from November's print of 3 percent, was sharper than a fall to the 2.7 percent rate expected by the market, slowed by volatile food costs.

PRICE PRESSURES TO PICK UP IN 2014

Food prices rose 4.1 percent in December from a year earlier, slowing from November's 5.9 percent rise, the National Bureau of Statistics said on Thursday.

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Month-on-month, consumer prices rose 0.3 percent versus 0.4 percent expected by economists.

But analysts warn inflation may quicken in coming months as the government pushes market-oriented reforms to liberalize energy and utility prices.

"While CPI inflation came in lower than expected, the January figure will likely exceed 3 percent again due to the Chinese New Year effect," said Zhou Hao, an economist at ANZ in Shanghai.

"Inflation could exceed 3.5 percent in the second half of 2014, as upcoming pricing reforms could push up commodity and public utility prices. Therefore, we think that CPI inflation will be 3.2-3.4 percent on average this year."

China's inflation was 2.6 percent over the whole of 2013, well within the government's target limit of 3.5 percent, the bureau said. Analysts believe the government will also stick with the 3.5 percent inflation target this year.

The bureau also said that China's producer prices fell 1.4 percent last month from a year earlier - the 22nd consecutive month of decline - versus the same rate of factory price deflation in November.

DELEVERAGING

Analysts expect the Chinese authorities to rein in the sprawling shadow banking sector under their long-term deleveraging drive in a bid to put the world's second-largest economy on a more sustainable footing.

Reuters reported earlier this week that the State Council, China's cabinet, had issued new policies to strengthen regulation of off-balance-sheet lending in an effort to contain the risk of a debt crisis.

"Inflation is not a major concern at this stage, but the crackdown on shadow banking will likely intensify, and financial institutions may need to deleverage further," Zhiwei Zhang, China economist at Nomura in Hong Kong, said in a research note.

The inflation news precedes December trade figures due on Friday and fourth-quarter gross domestic product data due on Jan 20.

Economists polled by Reuters forecast annual economic growth could slow to 7.6 percent in the fourth quarter from 7.8 percent in the previous quarter, putting 2013 GDP expansion on track for the weakest showing in 14 years.

Chinese leaders have pledged reasonable growth in 2014, and sources at top government think tanks told Reuters they expect a growth target of 7.5 percent, the same as for 2013.

(Editing by Eric Meijer & Kim Coghill)

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	1-MONTH	3-MONTH	6-MONTH	9-MONTH	1-YEAR
1-YEAR	1.00%	1.00%	1.00%	1.00%	1.00%
30-Year Fixed	4.25%	4.25%	4.25%	4.25%	4.25%
15-Year Fixed	3.50%	3.50%	3.50%	3.50%	3.50%
10-Year Fixed	3.25%	3.25%	3.25%	3.25%	3.25%
5/1-Year ARM	3.50%	3.50%	3.50%	3.50%	3.50%
30-Year Fixed Refi	4.00%	4.00%	4.00%	4.00%	4.00%
15-Year Fixed Refi	3.25%	3.25%	3.25%	3.25%	3.25%
5/1 ARM Refi	3.25%	3.25%	3.25%	3.25%	3.25%
30-Year Fixed Jumbo	4.50%	4.50%	4.50%	4.50%	4.50%

Source: Bank of America

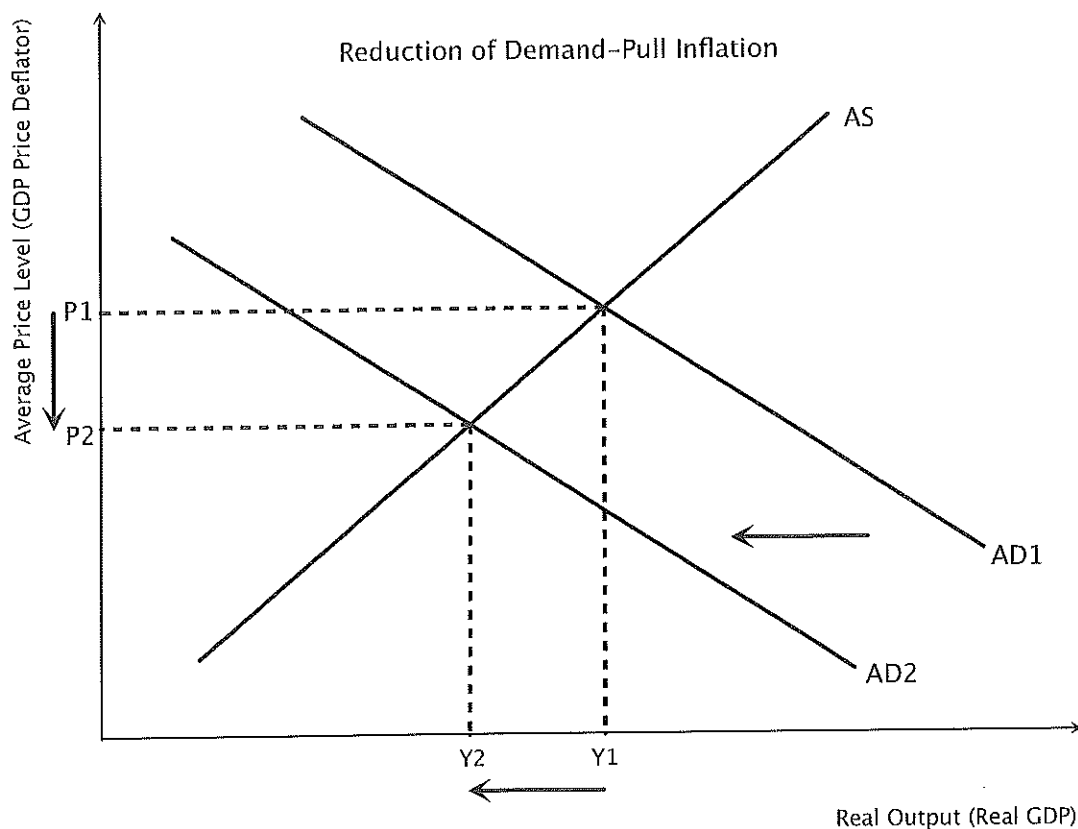
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One of the government's macroeconomic objectives is a low and stable rate of inflation. Inflation is defined as the sustained increase in the average price level of an economy, usually measured by the Consumer Price Index. The Chinese government's target limit of inflation is 3.5% in 2013 and 2014. While consumer inflation slowed to a seven-month low of 2.5% in December, analysts predict that inflation will rise in 2014, while economic growth, another macroeconomic objective, may slow.

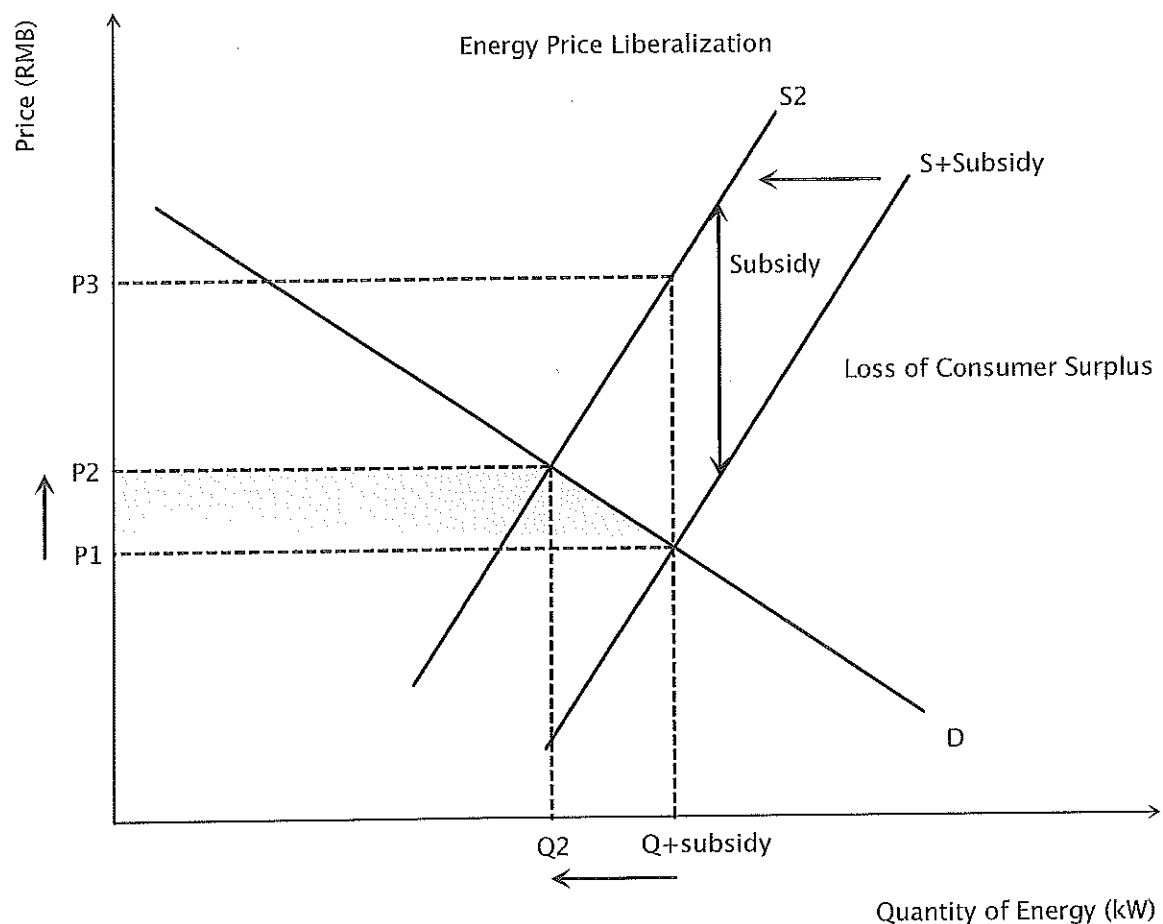
Governments wish to maintain a low inflation rate as this maintains households' purchasing power, makes the economy competitive internationally and reduces uncertainty. The recent low inflation rate has eased fears of a deflationary monetary policy, where interest rates are increased to increase the cost of borrowing. Borrowing becomes less attractive, and reduces components of aggregate demand (AD), consumption and investment. AD ultimately contracts, which reduces demand-pull inflation as prices fall from P_1 to P_2 .



However, inflation is expected to rise in the short and longer term. In January, inflation will "exceed 3 percent again due to the Chinese New Year effect", as consumers purchase in large amounts for the annual occasion. Furthermore, the government is pushing for "market-oriented reforms to liberalize energy and utility prices". Liberalization is when a planned economy like China transitions to a market economy, lifting its price controls through privatization and reduction of government intervention. In this case, state-owned energy and utility enterprises will be privatized and no longer subsidized. Inflation spikes as a result, due to the removal of characteristic underpricing of energy in a planned economy, which results in the "push up [of]

commodity and public utility prices”, and monetary overhang where the repressed inflation is followed with a swift spending of accumulated monetary savings. Analysts expect inflation then to “exceed 3.5 percent” as a result, but still to average at “3.2-3.4 percent” in 2014, which is within the government target limit.

While liberalization results in high inflation as price levels increase following planned economy distortions, it is an important structural reform for resources to be allocated more efficiently. As illustrated below, low-cost energy meant excess demand previously, at the controlled consumer price P_1 and quantity demanded $Q_{+subsidy}$. The world market price is higher at P_2 . After liberalization, domestic consumption falls to Q_2 and there is a loss of consumer surplus (blue area). Previously, the government subsidized energy imports to maintain the lower controlled price and satisfy excess domestic demand. Now, there is less government expenditure since the value of $Q_{+subsidy}(P_3-P_1)$ is no longer spent on energy subsidies. This eliminates the opportunity cost of government revenue previously spent on energy subsidies to be reallocated more efficiently. However without the subsidy, producers’ revenue fall from $P_3Q_{+subsidy}$ to P_2Q_2 . This may disincentivize producers and lead to lower energy production.



With inflationary pressure currently under control, the government wishes to focus on “policies to support growth while implementing structural reform measures”. The reform refers to long-term deleveraging, defined as the reduction of debt levels, in both the private and public sectors, measured by the decline in debt to Gross Domestic Product (GDP) ratio. While the shadow banking system increases liquidity in the economy that can stimulate AD, the system’s lack of regulation increases systemic risk, the risk that a whole financial system collapses. Deleveraging is to manage the shadow banking sector and “contain the risk of a debt crisis”, however it has several associated repercussions. The most common method of deleveraging is austerity and reduced spending, to reduce debt and increase net savings. Reduced consumption negatively impacts AD and economic growth, and recession can be a consequence of deleveraging. Indeed, economic growth is forecasted to “slow to 7.6 percent in the fourth quarter”, making 2013 GDP expansion “the weakest showing in 14 years”.

The alternative method is to increase GDP growth swiftly to naturally decrease the debt to GDP ratio. This would be a preferable solution but with the central bank pledging “prudent monetary policy” Chinese policymakers have only promised “reasonable growth”, likely at the same GDP growth target as 2013 of 7.5%. The last alternative of deleveraging is high inflation. This increases nominal GDP growth, which decreases the debt to GDP ratio. However, this is an unsuitable option if China wishes to maintain its inflation levels.

The achievement of one macroeconomic objective can often come at the expense of another. China’s economy must seek the best balance between economic growth and low inflation amid its economic structural reform of liberalization and deleveraging to ensure steady and sustainable economic development.